No. 89-336

In The

Supreme Court of the United States

October Term, 1989

JEFFREY KRINSK,

Petitioner,

v.

FUND ASSET MANAGEMENT, INC., MERRILL LYNCH ASSET MANAGEMENT, INC., MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., MERRILL LYNCH & CO., INC., and CMA MONEY FUND,

Respondents.

On Petition For a Writ Of Certiorari To The United States Court of Appeals For The Second Circuit

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

A) The Legal Standard By Which Claims Of Breach Of Fiduciary Duty Under Section 36(b) Are To Be Judged Is An Important Issue Which Has Been Wrongly Decided Below

The petition for certiorari contends that the courts below have improperly interpreted the remedial provisions of the Investment Company Act of 1940 ("ICA") and have imposed an unduly restrictive standard of review. Such improper standard should be reviewed by this Court, especially in view of the tremendous amount of the nation's wealth that is held in investment companies and subject to such standard. Over one trillion dollars are invested in investment companies and it is absolutely critical that the advisers are held to the proper fiduciary duty standard.

The courts below continue to review advisory compensation under a "corporate waste" standard in spite of the fact that in the 1970 Amendments to the ICA Congress rejected the "corporate waste" standard and instead commanded that investment advisers be charged with a "fiduciary duty" under Section 36(b), 15 USC § 80a-35(b).

The respondents' answering brief, pages 6-7, admits that the courts below held that:

> To be guilty of a violation of § 36 . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining.

(citing *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983), and quoted by the Court hereinbelow. (App. 110)).

The respondents' answering brief, however, denies that this standard is "tantamount" to the "corporate waste" standard that the respondents admit was rejected by Congress (Respondents' Brief p. 7 n. 4).

The test imposed by the courts below is, however, identical to the "corporate waste" test. In *International Insurance Co. v. Johns*, 874 F.2d 1447, 1461 (11th Cir. 1989), the Circuit Court held that "corporate waste exists when the payment is afforded without adequate consideration" (citing *Michelson v. Duncan*, 407 A.2d 211, 217 (Del. 1979)). In testing for such corporate waste the 11th Circuit held:

> A Court should examine whether the compensation was so unreasonably disproportionate to the benefits created by the exchange that a reasonable person would think the corporation did not receive a *quid pro quo*. *Fidanque v. American Maracaibo Co.*, 32 Del. Ch. 262, 92 A.2d 311, 321 (Del. Ch. Ct. 1957).

Johns, 874 F.2d at 1447. *See also Gottlieb v. Heyden Chemical Corp.*, 33 Del. Ch. 82, 90 A.2d 660, *reargument denied in part*, 92 A.2d 594 (Sup. Ct. Del. 1952).

In *Weiss v. Temporary Investment Fund*, 516 F. Supp. 665 (D. Del. 1981), *aff'd*, 692 F.2d 928 (2d Cir. 1982), *vacated* (on other grounds), 465 U.S. 1001, 104 S. Ct. 989, 79 L.Ed.2d 224 (1984), the District Court said:

> The leading case applying the doctrine of "corporate waste" to derivative actions challenging investment advisers fees was *Saxe v. Brady*, 184 A.2d 602 (Del. Ch. 1962). Under this doctrine if the stockholders have ratified the investment advisory contract a derivative suit will succeed only if the plaintiff establishes that "what the corporation has received is so inadequate that no person of ordinary sound business judgment

> would deem it worth what the corporation was paid" *Id.* at 610. Application of the corporate waste doctrine virtually insulated investment advisory fees from judicial scrutiny.

The standard applied by the courts below is thus indistinguishable from the corporate waste standard. The ICA is therefore not being given the remedial effects congress intended to impose by the "fiduciary duty" provided under Section 36(b).

This Court, in *Daily Income Fund v. Fox*, 464 U.S. 523, 534, 104 S. Ct. 831, 837, 78 L.Ed.2d 645 (1984), noted that a derivative action could be brought on behalf of an investment company under state law for corporate waste. Surely Congress intended ICA Section 36 to hold investment advisers to a stricter standard than was already available in a state court action for corporate waste.

Petitioner submits that an investment adviser, by virtue of its fiduciary duty, must give an investment company its "best deal" for the services it provides. In this case there is a compelling comparison between the CMA Fund at issue here and a sister fund, the RAT fund, which receives the same advisory services at a lower fee rate. The respondents' brief implies that the CMA fund is getting Merrill Lynch's best deal. This simply is not the case. The courts below have *not* found that CMA enjoyed the adviser's best fee rates. In fact, the Second Circuit specifically refused to apply such a fiduciary standard. Not only has the Second Circuit declined to require that the CMA Fund receive Merrill Lynch's best deal, the Second Circuit did not find that the fee charged was in fact reasonable.

Respondents' brief seeks to distinguish the fiduciary duty imposed by ICA Section 36 from standards traditionally imposed upon fiduciaries,* and thus would lower the standard for the fiduciary duties of investment advisers. As was aptly stated in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928) (Cardozo J.):

> Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions (*Wendt v. Fischer*, 243 N.Y. 439, 444). Only thus has the level for conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this Court.

Although respondents' brief, presumably in an attempt to justify Merrill Lynch's failure to give the Fund its best deal, boldly claims that the courts below found CMA Fund's performance has been "superior," the courts below noted that risk-adjusted performance was not but should be considered. (App. 57). There was no finding that risk-adjusted performance of the CMA Fund was superior. On the contrary, it was markedly inferior. Similarly, respondents proclaim that there was a "failure of proof" on the issue of whether Merrill Lynch realizes

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* As stated in the petition for certiorari, fiduciaries are held to the highest standards and must give their *cestui* their best deal. *E.g., Stone Mountain Game Ranch, Inc. v. Hunt*, 746 F.2d 761 (11th Cir. 1984); *United States v. Bush*, 522 F.2d 641 (7th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); *Edelman v. Freuhauf Corp.*, 798 F.2d 882 (6th Cir. 1986). When Congress chose the term "fiduciary duty," it was using words of art that should be given their accepted meaning. As show in these cases, "fiduciaries" are uniformly held to the highest standards of conduct.

significant economies of scale. The Court below agreed that plaintiff's exhibits show that fee-based expense, expressed as a percent of fee-based revenues, did decrease at a time when Fund size grew. (App. 80). Nevertheless the Court did not require the fiduciaries to share such savings with the *cestui*.

Respondents' brief also asserts that petitioner failed to quantify any fall-out benefits (*i.e.*, indirect profits to Merrill Lynch attributable in some way to the existence of the Fund). The Court below did find that Merrill Lynch enjoyed extra profits from revenues integrally related to the CMA Fund. The District Court hesitated to attribute *all* those benefits to the Fund saying "there is no reason to believe that a portion of these profits would not have been received . . . *but for* the existence of the Fund." (App. 76). Since the benefits to the adviser from the profits of the CMA Program were integrally related to the CMA Fund, they should have been weighed in full in determining whether the fiduciary over-reached. The Court below ignored this factor by treating these integral benefits as fall-out benefits and improperly requiring a "but for" causation test.

B) ICA Section 12(b) Provides Important Safeguards Against Misuse Of Shareholders' Investments For The Benefit Of Investment Advisers; This Court Should Rule On The Shareholders' Ability To Enforce Such Safeguards By A Private Action.

Respondents next argue that no private right of action should be implied under ICA Section 12(b) or Rule 12b-1. Rule 12b-1(e) imposes a fiduciary standard on

directors approving payment of fund assets for distribution expenses. Where fiduciary duties are imposed it is customary to imply a private right of action in favor of the beneficiary. *Rosenfeld v. Black*, 445 F.2d 1337, 1345 (2d Cir. 1971), *cert dismissed*, 409 U.S. 802 (1972); *Tannenbaum v. Zeller*, 552 F.2d 402, 413, 415 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977); *Jerozal v. Cash Reserve Management, Inc.*, [1982-83 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,019 (S.D.N.Y. August 10, 1982).

Respondents here, as the defendants in *Bancroft Convertible Fund v. Zico Investment Holdings Inc.*, 825 F.2d 731, 733 (3d Cir. 1987), "makes no persuasive argument . . . which suggests congressional intention to treat the prohibition . . . differently, for purposes of private enforcement, than the various other prohibitions in the Act which are also intended to protect investors." Section 12(b) is designed to protect investors from having to finance advertising and distribution expenses which may increase advisory fees to the adviser without benefitting the fund or its shareholders. Shareholders must be allowed to enforce such protections in order for the protections to be meaningful.

C) This Court Should Grant Certiorari To Determine Petitioner's Right To A Jury Trial.

Respondents' brief asserts that the Seventh Circuit has ruled that no jury trial is available for claims under ICA Section 36, citing *Kamen v. Kemper Financial Services*, 659 F. Supp. 1153 (N.D. Ill.), *mandamus denied*, No. 87-1455 (7th Cir. Apr. 13, 1987), *cert. denied*, 108 S.Ct. 1119 (1988). The Seventh Circuit actually refused to determine the

jury issue on a petition for a writ of mandamus. The Seventh Circuit has never decided whether a jury trial is available as required by the Seventh Amendment to the Constitution. In a dissent from this Court's denial of certiorari on the Seventh Circuit's decision denying mandamus, Justice White noted that the Seventh Circuit's failure to grant mandamus was inconsistent with the other circuits. Striking the jury demand is also inconsistent with this Court's holdings in *Beacon Theatres Inc. v. Westover*, 359 U.S. 500, 79 S.Ct. 948, 3 L.Ed.2d 988 (1959), and in *Curtis v. Loether* 415 U.S. 194, 94 S.Ct. 1005, 39 L.Ed.2d 260 (1974).

CONCLUSION

For the reasons stated above and in the petition the petition for a writ of certiorari should be granted.

Dated: New York, New York
October 6, 1989

Respectfully submitted,

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